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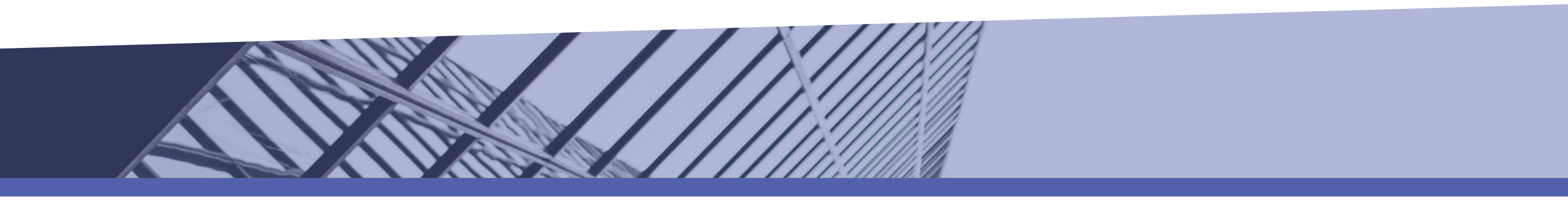

USHERING IN THE REIGN OF TRUMP

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Confounding pollsters, Donald Trump has emerged victorious from the US presidential elections. Markets have reacted, with global equities and US Treasury yields falling as expected. But how will a Trump presidency ultimately affect markets and the global economy? Our chief economist, Lenny McLoughlin, explores the possible outcomes.

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Before markets opened in Europe, Asian equity markets were 3.5–5% lower, as the initial reaction was a risk-off move. US equity futures markets were down 4.5–5%, but have since improved from pre-market lows to -2%. At the time of writing, the Mexican peso (seen as vulnerable to potential trade restrictions under Trump) is down 8% against the US dollar, while US 10-year Treasury yields are up by four basis points (bps) and German 10-year yields are unchanged. The euro is up by approx. 0.5% against the US dollar. The initial opening in European markets was steady, with equities falling by 2% before recovering to -0.5%.

Trump represents a move away from the 'political establishment' and a move into the unknown, given his more radical (but sometimes unclear) policy proposals. This creates uncertainty within markets. The initial equity market falls are in line with our expectations in the event of a Trump victory.

However, greater clarity is required from Trump in the coming days and weeks regarding his policy proposals. Investors will be closely watching for any possible changes in rhetoric compared to the stance he adopted through the campaign. Markets are likely to remain nervous and uncertainty could linger until it becomes clear what the policy mandate during his presidency will be, and how quickly any policy measures are likely to be implemented. Any initial suggestions that trade restrictions will be implemented quickly could fuel further nervousness and concerns. On the other hand, indications that fiscal stimulus measures are to be implemented in full could provide relief in the medium term, as measures are rolled out over a number of years.

Below we outline some of the key issues and concerns for markets that result from a Trump Presidency.

The immediate aftermath

As we've seen, Trump's victory has prompted an expected market reaction. The extent of these moves will be determined by control of congress and indications to the policy agenda President Trump intends to follow. The longer the period of uncertainty surrounding the policy agenda lasts, the more volatile and weak equity markets could be expected to be. We expect emerging markets to be most exposed and vulnerable, due to the potential for protectionist policies targeting China and Mexico.

A lack of clarity in relation to budget details, specifically around commitment to various policy proposals, could also contribute to uncertainty. This could take many months to resolve.

Exhibit 1: Initial expected reaction to Trump victory

US equities	-3/-5%
EM equities	-7/-8%
Global equities	-4/-6%
US 10-year yields	-5/-15bps
German 10-year yields	-5/-15bps
US dollar	-1/-2%

Source: ILIM

If we consider market returns on a historic basis, we see that returns in election years, and in the fourth quarter of election years, tend to be slightly lower than average returns over the long run.

Exhibit 2: Initial expected reaction to Trump victory

Time period	Non Election Years	Presidential Election Years
Q4	4.0%	1.7%
Whole Year	8.3%	6.1%

Source: Bloomberg

What are the issues that could affect markets?

Clearer guidance on the policy agenda and its budget implications would be required to defuse this policy-related uncertainty. Only then could investors make a judgment in terms of the ultimate impact on underlying fundamentals and markets.

We have identified several key issues relating to the presidential election, which will determine the impact on the economy and markets. These relate to control of congress, fiscal policy, trade, monetary policy and the effect on the US dollar. Let's consider each of these in turn.

Congress control

Given the checks and balances within the US political system, one of the key determinants of policy under the next US president is control of Congress. Under single-party control, with the same party controlling the presidency, and both chambers within Congress, the Senate and House of Representatives, the implementation of the policy agenda would be viewed as much more easy to achieve.

Republicans are set for a majority in both chambers of Congress, implementing policy proposals should be easier for Trump although his relationship with key Republican leaders has been strained through the campaign. This should facilitate an easier and more complete implementation of Trump's mandate.

Fiscal policy

Trump's fiscal stance is likely to be both more expansionary and much more aggressive. He has suggested up to $1 trillion of infrastructure spending, but his proposals have varied and have not been confirmed. He has also suggested substantial cuts in corporate tax rates and reductions in income tax rates. Independent analysis of the proposals suggests the fiscal deficit could widen by up to 4% p.a. under a Trump presidency. Depending on his ability to push these proposals through Congress to the size and extent outlined by his campaign, and based on the multiplier effect of fiscal policy, there could be a significant positive impact on US growth. This is expected to be in the region of 1–2%, and would probably be evident in 2018 rather than 2017.

Trade

Trump has been vocal in his opposition to greater free trade and has opposed the Trans Pacific Partnership agreement. He has also suggested NAFTA should be renegotiated.

Other radical suggestions include tariffs on imports from China and Mexico, countries with which the US has large deficits. Trump has even raised the possibility of withdrawing from the World Trade Organisation.

In general, the US president has greater independence and authority in relation to trade issues compared with other policy matters. They can unilaterally, under certain circumstances, impose tariffs on imports from particular countries to protect US interests without requiring congressional approval. The president can also withdraw from trade agreements on a unilateral basis. The president does, however require congressional approval in relation to the terms of any new trade agreements.

Given Trump's rhetoric during the campaign, we would expect him to introduce some protectionist trade measures against China and Mexico. Depending on the severity of these measures, they could lead to a retaliatory response from both countries. This would obviously have a negative impact on US and possibly global trade.

Any policies to limit immigration into the US, which Trump has suggested, would also have a negative impact on US growth potential. Such policies would limit the pool of labour and could also drive increased wage pressures in the US.

It has been estimated that if Trump were to implement protectionist policies to the most extreme level suggested, the negative impact on global growth (without any other offset) could be up to -0.75%. This outcome would be particularly negative for emerging markets countries, but also could also push many developed countries close to recessionary conditions.

Monetary policy

Trump's approach could impact monetary policy in many ways. He has been highly critical of the Federal Reserve during the campaign, suggesting interest rates have been kept lower for longer than they should have been for political reasons. He has suggested an audit and possible review of the Fed's mandate. It is unlikely that Janet Yellen would be reappointed as Fed chairperson under a Trump presidency in 2018; she could even leave the post before her term expires. Any uncertainty relating to the tenure of key members of the Fed, or possible changes to its inflation policy mandate and 'modus operandi', could give rise to uncertainty. Specifically, questioning the Fed's independence and credibility could put upward pressure on US yields and interest rates.

Similarly, any moves towards protectionism could lead to higher inflationary pressures via higher import costs and wage costs, which would probably feed through to higher yields and interest rates.

All other things being equal, Trump pursuing looser fiscal policy to support growth could lead to tighter monetary policy being implemented by the Fed. On the other hand, the immediate uncertainty following his victory could deter the Fed from raising interest rates in December. Central bankers may prefer to wait and see what the policy implementation and its implications on growth and inflation would be under Trump.

US dollar

The impact on the US dollar is a factor more difficult to determine.

On the negative side, a lower likelihood of a Fed rate hike in December following Trump's election would be negative for the US dollar. Similarly, as happened recently to sterling following the Brexit referendum, the perceived potential for a lower return on capital in the US due to Trump's policy proposals could lead to weakness in the dollar. Meanwhile, a move to greater protectionism could prompt overseas holders (such as China) of US assets to dump/sell them. This too could have a negative impact on the dollar.

However, the impacts of a Trump presidency on fiscal and monetary policy we mentioned previously could also affect the US dollar.

Although Trump has expressed a preference for a weaker US dollar, the expectation of looser fiscal policy and possibly higher inflation from protectionist measures could result in tighter monetary policy in the medium term. This could strengthen the US currency.

Efforts by Trump to encourage repatriation of cash held overseas by US corporates under any new tax proposals could also lead to dollar strength. So could the increased levels of global uncertainty, as the dollar tends to benefit as a safe haven asset at such times.

We're six months on from the Trump victory. How do markets look?

The medium-term market reaction to a Trump victory depends on the extent to which Trump can implement his policy proposals.

Trump could implement protectionist policies much more easily and more quickly than any fiscal stimulus proposals. If these were to be introduced relatively quickly and aggressively, with no offsetting fiscal stimulus, this could increase the downside risk in equity markets on a six-month view by up to 5% compared with the above figures.

As Republicans now control congress, many of the negatives on US growth associated with protectionist policies could be offset with a large fiscal stimulus. If a fiscal package to the extent that Trump has been suggesting were to be implemented, losses in US and global equities could be recovered if fiscal proposals became clearer. We see possible upside in equities of 5%+ from pre-election levels depending on the scale of any fiscal stimulus. The upside for emerging markets equities, however, would probably be less, and would depend on the scale of protectionist measures introduced.

However, it is not certain that Trump could implement a large fiscal package, even with Republican control of congress, given the possibility of some reluctance among Republican leaders to adopt such a loose fiscal policy. Also, under recent legislation, measures which increase the deficit over a period of 10 years are not permitted.

In terms of yield levels, in the event of no fiscal offset against offset protectionist measures, growth and deflationary risks would probably ultimately put downward pressure on yields. Yields could even fall further to new lows.

If a large fiscal stimulus were evident in the US, US yields could rise by 30–50 basis points over the medium term. There could be modest upward pressure on German and other yields if investors assumed that any US fiscal stimulus was going to be replicated elsewhere.

In the short term, the US dollar could weaken if the prospect of a December interest rate rise was seen to have diminished. In an environment of higher US yields and interest rates due to improving US growth following a large fiscal boost, gains in the US dollar of 5%+ compared with pre-election levels could be expected.

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